Pozières Consulting

Expropriation Risk

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Executive Summary

As overall global economic interconnectivity continues to promulgate, so does the pressure on companies to expand into developing markets in search of growth opportunities. This leap into the unknown carries with it a number of new risks for many companies not used to the complex business environments of developing economies where political factors often have an equal, if not greater, impact on financial outcomes than do economic factors. To assist companies in navigating through this confluence of business and politics, Pozières Consulting Inc. is releasing a set of reports dealing with specific political risks; this report will be dealing with expropriation risk.

Introduction

With both the United States and Europe suffering from systemic growth concerns and poor aggregate returns by historical standards, companies and investors are allocating more and more capital to developing markets. This increased interest has resulted in a marked increase in Foreign Direct Investment; in 2014 Foreign Direct Investment flows to developing markets increased by 2 per cent to reach their highest ever level at $681 billion, accounting for 55 per cent of global FDI inflows. Five of the top 10 recipient economies now are developing ones.

Region	FDI inflows		
	2012	2013	2014
World	**1 403**	**1 467**	**1 228**
Developed economies	679	697	499
Europe	401	326	289
North America	209	301	146
Developing economies	639	671	681
Africa	56	54	54
Asia	401	428	465
East and South-East Asia	321	348	381
South Asia	32	36	41
West Asia	48	45	43
Latin America and the Caribbean	178	186	159
Oceania	4	3	3
Transition economies	85	100	48
Structurally weak, vulnerable and small economies[a]	**58**	**51**	**52**
LDCs	24	22	23
LLDCs	34	30	29
SIDS	7	6	7
***Memorandum:* percentage share in world FDI flows**			
Developed economies	48.4	47.5	40.6
Europe	28.6	22.2	23.5
North America	14.9	20.5	11.9
Developing economies	45.6	45.7	55.5
Africa	4.0	3.7	4.4
Asia	28.6	29.2	37.9
East and South-East Asia	22.9	23.7	31.0
South Asia	2.3	2.4	3.4
West Asia	3.4	3.0	3.5
Latin America and the Caribbean	12.7	12.7	13.0
Oceania	0.3	0.2	0.2
Transition economies	6.1	6.8	3.9
Structurally weak, vulnerable and small economies[a]	**4.1**	**3.5**	**4.3**
LDCs	1.7	1.5	1.9
LLDCs	2.5	2.0	2.4
SIDS	0.5	0.4	0.6

Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).
[a] Without double counting countries that are part of multiple groups.
Note: LDCs = least developed countries, LLDCs = landlocked developing countries, SIDS = small island developing States.

While returns may appear higher in developing markets, there are a number of significant political risks associated with these investments. While these risks are being noticed, they are not being fully integrated into formal Enterprise Risk Management (ERM) systems and thus are not being measured effectively as potential financial risks. Of the 1,200 executives who responded to a recent survey by McKinsey, the majority cited geopolitical instability as the top risk to global growth and the most recent EIU's Global Business Barometer showed that the proportion of executives that identified political risk as one of their main concerns increased from 36 percent in 2013 to 42 percent in 2014. However, a Pozières Consulting survey that found similar recognition of geo-political risk also found that despite the awareness, less than 8% of respondents felt that they adequately integrated political risk into their investment decision making process.

When headline political risks are broken down into specific political risks there is also a serious disconnect between perceived concerns and reality; a World Bank survey found that less than 5 percent of investors expressed concerns about the possibility of expropriation risk specifically, despite it being the most expensive political risk category.

While political risks such as restrictions on capital transfers and civil war are more common in terms of the number of claims, expropriation risk dominates in dollar terms. Of all the dollars paid out by OPIC from 1970-1978, 96% of these claims were for expropriation. From 1991-2004, even after the major financial crises that triggered a number of transfer claims, 84% of funds paid out in political risk insurance settlements by the US Overseas Private Investment Corporation (OPIC) were for expropriation. Some claims represented huge payouts such as the $217 million claim by MidAmerican Energy Holdings against the government of Indonesia.

The Investor-state dispute settlement (ISDS) system has awarded claims in excess of $1 billion each in more than 65 cases (See Figure 2).

The number of cases and countries involved

- 608 known treaty-based ISDS cases brought
- 99 governments have been respondents
- 70 per cent of all known cases brought against developing and transition economies
- 80 per cent of all known claims brought by investors from developed countries

Results of 405 concluded ISDS cases (see chapter III)

- 36 per cent in favour of the State
- 27 per cent in favour of the investor
- 26 per cent settled

Amounts claimed and awarded

- $1.1 billion in damages claimed in a case, on average (based on 447 cases for which this information is available)
- 65 known cases with claims exceeding $1 billion
- 37 cases with claims between $500 million and $999 million
- $575 million in damages awarded, on average (based on 106 cases for which this information is available; amounts do not include interest)
- $40 billion – largest amount ever awarded by an investment tribunal (UNCTAD, 2015)

ISDS cases by economic sector
(Per cent)

State conduct most commonly challenged by investors
(preliminary data based on cases where information is available)

- Cancellations or breaches of investment contracts (29 per cent of cases)
- Legislative changes (25 per cent)
- Direct expropriation or seizure of investment (15 per cent)
- Tax-related measures (11 per cent)
- Refusal to grant or revocation of licenses (8 per cent)
- Abusive treatment or failure to protect investment (7 per cent)

Other challenged measures relate to judicial acts or omissions, withdrawal of incentives, freezing of bank accounts, sovereign debt restructuring, damage from armed conflict, interference with management of an investment, and measures to combat the 2001 financial crisis in Argentina.

The FDI background to ISDS (economic context)

- $27 trillion in global FDI stock
- 100,000 multinational companies
- 890,000 foreign affiliates worldwide

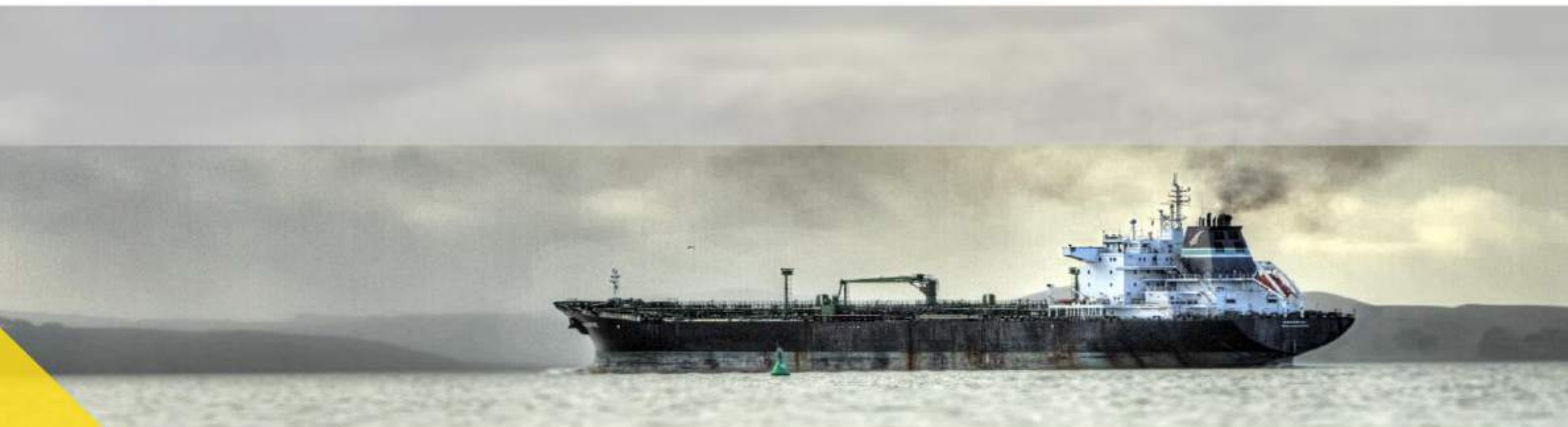
Source: UNCTAD.

Figure 2.

Over the past five years there has been a steady increase of expropriatory actions by governments against foreign investors. While the nature of the expropriatory actions has shifted somewhat towards more indirect expropriations as opposed to direct expropriations, even the latter has seen an increase. According to the World Bank's Multilateral Investment Guarantee Agency (MIGA), since the Arab Spring of 2011, the demand for Political Risk Insurance has spiked significantly as firms begin to appreciate the complex political risks associated with developing markets.

Despite the increased risk and the recognition by business leaders of political risk as a driver of financial outcomes, robust measurement and integration of political risks have yet to be adequately integrated into many companies ERM systems and thus political risks are not being properly monetized or included in Return on Investment (ROI) calculations in real revenue terms and thus they are often reduced to footnotes in the advice to board members and CEO's.

To properly manage and account for political risks, specific risks such as expropriation risk must be identified, analyzed, monetized and integrated into board level corporate decision making, preferably within the framework of a company-wide ERM system.



What is Expropriation Risk

Expropriation risk is a sub category of risks associated with political risk and therefore it may help to start with a definition of political risk.

Political risk broadly defined is the probability of disruption of the operations of companies by political forces and events, whether they occur in host countries or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions not only of governments and political institutions, but also of minority groups and separatist movements. The most direct form of political risk involves government initiated seizure of private assets but it also extends to include creeping forms of government intervention such as unexpected taxes or royalties on profits. Furthermore, political risk includes the instability of government policies as well as the strength of the legal system, especially with respect to the enforcement of property rights and the rule of law. Finally, internal and external conflicts, such as general strikes, terrorism, and civil or external war, form part of political risk.

Expropriation Risk itself is the loss of investment as a result of discriminatory acts by any branch of the government that may reduce or eliminate ownership, control, or rights to the investment either as a result of a single action or through an accumulation of acts by the government or political institutions within a country. Expropriation is not limited to an outright seizure of an investment or asset, known as direct expropriation, but also subtle or surreptitious forms of expropriation such as a series of discriminatory measures aimed at a specific investor, renegotiation of concessions, changes in the terms of commercial agreements, discriminatory fees or taxes, or the failure of governments to enforce property rights or political harassment of shareholder; these forms of expropriation are known as indirect or 'creeping' expropriation. Expropriation provisions usually cover both "direct" and "indirect" forms of expropriation. "Indirect expropriation" covers acts, or series of acts, whose effects are "tantamount to" or "equivalent to" a direct, formal taking. These are acts that generally involve total or near-total deprivation of an investment or destruction of its value but without a formal transfer of title to the State or outright seizure.

Relying on indirect expropriation protection can be difficult; what constitutes legitimate regulation and what is discriminatory or targeted legislation can be problematic and difficult to prove in court or to an insurer, especially if some practices are widespread. In a World Bank study of one thousand infrastructure projects awarded in Latin America between 1985 and 2000, it was estimated that 30 percent of all contracts were renegotiated.

Expropriation Risk even occurs in developed markets and therefore should form part of any investment risk assessment.

The History of Expropriation

The risk of expropriation was a major issue for investors in a post-World War 2 period that split the world ideologically and saw the independence of numerous countries from their colonial rulers. The first formal Bilateral Investment Treaties (BIT's) began to emerge with a heavy emphasis on expropriation. The proliferation of BIT's throughout the 1950's and 60's meant that BIT's became the main mechanism used to govern trade relations between governments. These developments were followed by the establishment of the International Centre for Settlement of Investment Disputes (ICSID) in 1965, a body providing a specialized facility for the resolution of investment disputes between investors and host governments. In 1958, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards was concluded, facilitating the enforcement of international arbitral awards.

As investment protections in BITs enhanced, including by adding ISDS provisions, the frequency and nature of expropriation events began to change. During the 1960s and 1970s, acts of expropriation came about in response to political risks centered largely on postcolonial declarations of independence, civil wars, and socialist takeovers; newly formed governments confiscated or nationalized foreign investors' property outright and formally. During this time estimates show that 15-20 percent of the volume of all U.S. Foreign Direct Investment abroad measured in volume terms was expropriated.

During this time many multinational firms, particularly those in the mining and banking sectors, began building in-house teams employing political scientists and former CIA and U.S. State Department personnel. These teams looked at risk assessments qualitatively, producing detailed local briefs outlining the political and security risks in developing and frontier markets. While providing sound insight into political instability and risks, these briefings failed to integrate cost-benefit methods or link political risks to financial outcomes in any meaningful way and therefore did not provide adequate or useful insights that could properly inform business and investment decisions. This problem still exists today for many organsiations.

The 1980's saw more liberal economic policies proliferating and a marked reduction in expropriations. During 1980-1986, estimates of the number of expropriations declined to 16.44 from a high of more than 500. The fall of the Berlin Wall in 1989 and the dissolution of the Soviet Union caused a sudden paradigm shift in geopolitics where political cooperation and economic integration increased rapidly. Throughout this period Bilateral Investment Treaties proliferated with an average of almost three new agreements signed per week. Although only 381 BITs existed at the end of the 1980s, the number grew to 2,067 by end of the millennium.

The 2008 economic crisis and the 2011 Arab spring suddenly brought expropriation risk back into context for investors as both direct and indirect expropriatory actions by governments began to rise again for the first time in more than 30 years. Statistics from the Berne Union, a large political risk insurance syndicate, demonstrate an ardent and rapid rise in the uptake of political risk insurance policies since the 2011 Arab Spring as investors look to hedge against an increasingly unstable geo-political landscape. Moves towards resource nationalism has seen a number of developing such as Guinea, Brazil and Ecuador revise mining legislation but more troubling has been high-income countries such as Australia and Canada doing the same.

As the world moves into a multipolar geo-political framework of international relations, global trade norms are now being openly challenged for the first time since World War 2 which is reducing the systemic disincentives for governments to engage in expropriatory behavior.

Recent Examples of Expropriation

US watch manufacturer - Philippines
Selective legislation was introduced against the insured. The manufacturer was required to raise salaries, which eliminated the profit and the reason for setting up such a facility in that country. This was a "creeping expropriation" claim for $37 million.

Hotel company - Egypt
The Egyptian government confiscated a hotel property, saying it was on holy ground. The government operates the hotel today.

Catering company - Argentina
Caught up in Argentina's recent economic woes, a U.S. company's dollar-denominated certificates of deposit were "pesified" (converted to the Argentina currency) and then access to them was severely restricted. Underwriters agreed that this amounted to expropriation by Argentine government.

Timber concession - Ecuador
Government cancelled a U.S. company's lumbering concession, then granted it to a third party, the nephew of the president of Ecuador.

European oil company - Central Asia
A joint venture invested many millions in a company to source sub-soil minerals. Before the company could start trading, the local government joint venture partners withdrew and canceled the contracts with the European partners, causing the Europeans to lose several million dollars.

Power project - India
The newly elected government of the state of Maharashtra in India unilaterally cancelled the contract for a $2.8 billion electric power generation plant to be built and owned by a consortium. Even after the new negotiations led to a revised deal, local press continued to criticize the arrangement as too generous for the foreign investor. Disputes between the power purchaser and the consortium resurfaced two years later, leading to the termination of the project. Arbitration is pending.

International Food Company – Venezuela
A tomato processing plant facing expropriation was sold by its U.S. company to the state government of eastern Monagas in Venezuela after state troops had occupied the facility. The payment made was well below the market value of the site.

(Sources: Aon, Pozières.)

Why Expropriate?

There are numerous interconnected factors and considerations that play that impact the levels of expropriation risk. Figure 3. lists some of the headline factors; while these factors can be important leading indicators in assessing levels of Expropriation Risk, they cannot be taken independently of other factors nor can they be considered direct causal variables. To properly understand expropriation risk and why these factors play a key but not direct causal role, we need to look at expropriation from a different perspective.

Key factors influencing Expropriation

Resource Nationalism
Economic downturns
High commodity prices
Ideology
Low central bank reserves
Financial crises'
Low levels of development

(Fig. 3)

Expropriation risk has three interconnected features that interact with the factors outlined in figure 3. – political capital, political constraints and cost-benefit analysis. Expropriation risk is essentially about political capital in the context of a cost-benefit analysis by a political leader, a government or a ruling party within the political constraints of the system they participate in. This cost benefit analysis is rarely defined by the best interests of the people, the country or the investor but a complex set of political considerations that has the survival and benefit of the decision makers at the center. Political capital or goodwill is essentially the leverage, support or strength of mandate that a ruler has with the ruled; political capital is gained through promises of, or delivery on political promises. In China for example, the legitimacy and political capital of the Chinese Communist Party is derived from the delivery of high economic growth as opposed to say, strong democratic institutions. Political constraints come in the form of factors such as rule of law, economic development, democratic institutions and military power.

In short, a government's willingness to expropriate is a function of weighing up a number of costs and benefits, both political and economic.

When viewed from this point of view, we can see that the type of political institution is exceptionally important when analyzing levels of expropriation risk. In democratic regimes for example, expropriatory actions are mostly taken by governmental actors other than the executive branch. Democratic regimes are also generally less likely to engage in expropriatory behavior compared with non-democratic regimes because of institutional features such as rule of law, checks of power, multiple players with veto power, and the importance of reputation to policymakers seeking re-election. The cost-benefit analysis in a democracy, along with the systemic political constraints tend to serve as a disincentive and thus a lower probability of expropriations. In fact, according to the ACLP Economic and Political Database, between 1960 and 1990, among 520 expropriation acts, autocratic governments committed 423 acts while democratic governments 97 acts.

Despite the strong body of evidence that strong democratic institutions are the most important factor when considering expropriation risk, leading Political Risk Insurance underwriters note that investors place more emphasis on regime stability than the type of regime or its political capital when analyzing expropriation risk. A key example of this dichotomy is Mozambique, where a number of international mining companies agreed to invest in large infrastructure projects on the basis of an ostensibly stable regime, ignoring the absence of real political constraints. Recent developments have seen Mozambique introduce a series of indirect expropriatory measures aimed at foreign owned mining companies through methods such as targeted taxation despite these measures being deemed unconstitutional. The lack of rule of law and unrestrained executive power means foreign investors are more easily subjected to the whims of the host government in Mozambique despite strong ruling stability.

In Context

Analysis shows that while factors such as crises' and high commodity prices are highly correlated with disputes between investors and host governments, expropriations themselves are not specifically correlated with these crises. The risk factors in figure 3. must be put into the context of being one factor in the political cost benefit analysis undertaken by a particular government. This cost benefit analysis includes a number of complex considerations, pressures and incentives that often make little economic or financial sense but in context make political sense. Some of these considerations are:

Access to international capital markets - being cut off can be a disaster, especially for countries running a budget deficit.

A decrease in Foreign Direct Investment – After Equador made a series of expropriations in the energy sector in 2008, the country saw FDI into the country plummet, especially in the energy sector where investment dropped from $825 million in 2007 to just $50 million in 2008.

Domestic politics – a backlash by voters or political elites can put governments under severe pressure such as the proposed 'carbon tax' in Australia which became such an unpopular policy that it played an important role in the incumbent government losing power.

Loss of access to modern technologies and knowhow – governments have tended to avoid expropriation in areas that require large numbers of highly-skilled and technical talent or advanced technologies that cannot be applied or run independently of foreign companies.

Resource Nationalism – Resource nationalism in countries such as Russia provide leaders with political capital and incentives to expropriate in strategic sectors as a means of restoring a state to a status of power or as a step towards rectifying some sense of injustices from their colonial pasts.

Dependence on foreign aid - Countries dependent on foreign aid are less likely to expropriate from foreign investors for fear of losing much needed aid funds; there is legislation in the United States that reduces foreign aid to states that expropriate without compensation.

International Relations - In venezuela for example, US companies face a far greater risk of expropriation than do firms from China or Russia. Equally, States rarely seize property or assets from allies or client states.

Low economic growth or financial crises' – During economic downturns politicians have an incentive to redistribute income from foreigners to domestic citizens thus increasing the likelihood of expropriations.

Central Bank Reserves - Low levels of central bank reserves are both a symptom and a predictor of future financial crises which can act as an incentive for expropriation.

Ideology – governments with strong mandates linked to a particular ideology are more readily inclined to engage in expropriatory actions given the positive political capital windfall from such actions; an excellent example of this kind of ideologically driven expropriation is case of the copper mining industry in Chile under the world's first democratically elected socialist government in 1971.

In context we can see that there are a number of interconnected factors at play when a government considers expropriation. We can also see that political constraints also play a major role in determining whether a government will engage in expropriatory activities. We can see for example that countries rich in natural resources and low in institutional or foreign constraints may be less concerned about access to international capital markets or domestic politics whereas countries that are dependent on foreign aid or access to international capital markets may be especially concerned about adverse actions against investors, especially if accompanied by strong political constraints.

Ultimately the ability and willingness of a government to expropriate is a function of a cost benefit analysis that includes the aforementioned variables and the political constraints in place.

Strategies for minimizing Expropriation Risk

With a fundamental understanding of how expropriation risk manifests, CEO's and business decision makers can undertake a number of strategies to minimize the associated risks when working in countries with high propensities towards expropriatory behaviour.

Host government financing and Joint Ventures

Joint ventures help protect foreign investors by integrating domestic interests with foreign interests and thus creating a disincentive for host governments to act in a way that would disadvantage domestic interests. Utilizing financing from host governments or local financial institutions also contributes to reducing host governments incentives to expropriate and reduces overall project risk. The major advantage of using joint venture arrangements when political risk is high is that joint venture arrangements allow for the control, monitoring and re-contracting mechanisms that would provide a means to redress unforeseen shifts in local business conditions and the political environment. A Joint Venture arrangement can provide for complex specifications of termination or dissolution clauses that can protect foreign investors. Spreading the benefit of foreign investment and creating local stakeholders whose best interests rely on the joint venture prospering without adverse government intervention can create powerful and motivated local supporters. An excellent example of a successful long running Joint Venture is the CR Snow joint venture between the beer brewer SABMiller and the state owned China Resources Enterprises.

Established in 1994 with the construction of 2 breweries, the Joint Venture, under the Snow brand has grown to become the world's largest beer brand by volume with more than 90 breweries across China.

Joint Ventures do however also carry their own risks. A close relationship with host governments for example can severely backfire on foreign investors when the host government suddenly loses power or is overthrown. The China National Petroleum Corporation (CNPC) experienced this when the Libyan regeme of Muammar al-Qaddafi was overthrown in 2011. Having had a very close relationship with the al-Quaddafi regeme, CNPC found their investments were at risk because of mistrust by the new government. Members of the Libyan opposition against the regime of Muammar al-Qaddafi attacked Chinese workers and infrastructure projects and as a result several projects were cancelled.

Due Diligence and Stakeholder Scanning

It is vitally important to undertake rigorous on the ground due diligence and stakeholder scanning on potential investment opportunities in countries where expropriation risk is high. Subtle, independent due diligence and stakeholder scanning can identify a number of hidden or obfuscated risks such as potentially challenging local governments, corruption, issues with local stakeholders such as tribes or community groups, as well as conflicting interests of political elites and politically connected partners. Stakeholders such as suppliers, consumers and surrounding communities are sources of data on social and political risk. Information can be gathered from surveys, interviews, surveillance, community meetings, market perception studies, and exploiting local contacts and sources. The drawback is that engaging stakeholders can sometimes embroil foreign investors in local politics or sensitive situations so it is advisable to seek assistance from a specialist third party firms who specialize in these areas.

In political environments where institutions are weak, engagement or partnering with political elites or politically exposed individuals, be that as suppliers, contractors or investment partners, who are not properly vetted can be a source of risk in countries where political power shifts or is unstable. Expropriatory behavior by shareholders through tunneling or self-dealing is far more severe where politically connected individuals or firms are involved versus when dealing with nonpolitically connected individuals or firms. There is a direct relationship between expropriation and political connections especially in relation to indirect expropriation. This can take the form of internal expropriation whereby shareholders use their political connections to force out foreign investors or from outside whereby host governments use political pressure on key shareholders to either force out foreign investors or both parties.

Where politically connected elites suddenly lose power or leverage with host governments, there is risk that the fallout will directly affect foreign partners. A perfect example of this is General Motors, the US car manufacturer owns a 25% stake in GM Uzbekistan, a car-making joint venture with Uzbek firm Uzavtosanoat. GM Uzbekistan has recently found itself in the middle of a war between political elites from rival clans who are vying to succeed the current President of Uzbekistan, Islam Karamov. At the centre of this power struggle is the Tashkent clan leader Rustam Inoyatov, who heads the state intelligence agency and the National Security Service, and who is using his powers to put pressure on his rivals. Unfortunately for GM, one of these rivals is Deputy Prime Minister Ulugbek Ruzikulov, who oversees domestic automotive production and who has close links with GM Uzbekistan. In unstable markets friends can become foes very quickly.

Projects, Funds, and Foundations

The network of relationships in a country greatly influences policy outcomes, especially in countries with weak political institutions. Collaborations with governments or other groups to establish programmes to ensure that communities share the benefits of international investments are useful tools for building trust and influence. Large mining companies have often used foundations to address governance issues, particularly with respect to corporate social investments and community integration. A number of companies have also adopted preferential procurement policies towards local suppliers, distributors and employees. The Italian energy company Eni has created a fund in Kazakhstan which funds the construction of various public works, including the national library, the prime minister's residence, schools, computer labs, and multifamily housing units for the poor. The company favours Kazakh over non-Kazakh suppliers and the majority of its Kazakh based workforce is made up of local Kazakh employees. As a result, many Kazakh officials now have a stake in Eni's success. At the Antamina mine in Peru, owned by BHP Billiton Plc, Mitsubishi Corporation, Noranda Inc., and Teck Cominco Ltd has developed a Sustainable Development Plan with the UN Development Programme, which delivers services such as roads, health, and education.

These strategies are not limited to developing countries, when Rio Tinto opened a mine at Yandicoogina, in Western Australia, the company signed what became the Yandicoogina Land Use Agreement with local Aboriginal communities in the area in which Rio Tinto committed more than US$46 million over 20 years in the form of long-lasting community development, training, employment, and business opportunities.

In Namibia, the Rossing mining company created the **Rossing Foundation** in 1979. The foundation is overseen by an independent Board of Trustees and is financed through donations from the earnings of the Rossing Mine. The company contributes 3% of its net earnings to the foundation, and by 1996 it had invested US$25 million. It is estimated that more than 15% of Namibians have benefited from the activities of the foundation. The Rossing Foundation's principal objective is to improve the living conditions of Namibians through activities such as informal education and training, a library network, and assistance to self-support programmes in the rural communities, particularly in the artisanal sector. The policy is to create projects principally in regions where Rossing employees were recruited. The activities of the foundation have grown enormously since 1990, and it is now an internationally accepted organization that between 1994 and 1996 administered US$10 million from other donors, including the World Bank, the European Community, and the US Agency for International Development. Strategic areas of investment are in line with government policy and accepted by the community. Key to the foundation's success is a bottom-up, participatory approach to decision-making and the priority given to the development of trust among all participants.

(Source: McMahon 1997)

Creating sustainable and responsible initiatives through projects, funds and foundations ensures that local stakeholders are benefiting and involved in the investment projects in their areas. This reduces the likelihood of expropriation by providing fewer reasons for locals to put pressure on central or local governments. Spreading the benefits by bringing in local stakeholders also creates a disincentive to expropriation as doing so would disrupt those benefits.

Political Risk Insurance

Political Risk Insurance comes in two forms, those underwritten by private institutions and those underwritten by public entities. In addition to providing compensatory value in the event of claims, Political Risk Insurance can help investors access finance and, in some cases, on better terms, increasing the size of available loans. Investors are often required to take up Political Risk Insurance in order to obtain financing from banks. For lenders, Political Risk Insurance can provide regulatory relief from country-risk provisioning requirements. When provided by multilateral and large national insurers, Political Risk Insurance can also help deter harmful actions by host governments, help resolve investment disputes, and provide access to best practices in environmental and social standards.

Private firms like Marsh & McLennan, the Berne Union, Hiscox, Willis, and Aon offer protections for potential losses due to expropriation. Sometimes however private firms cannot or will not cover certain investments because the investment is simply too large.

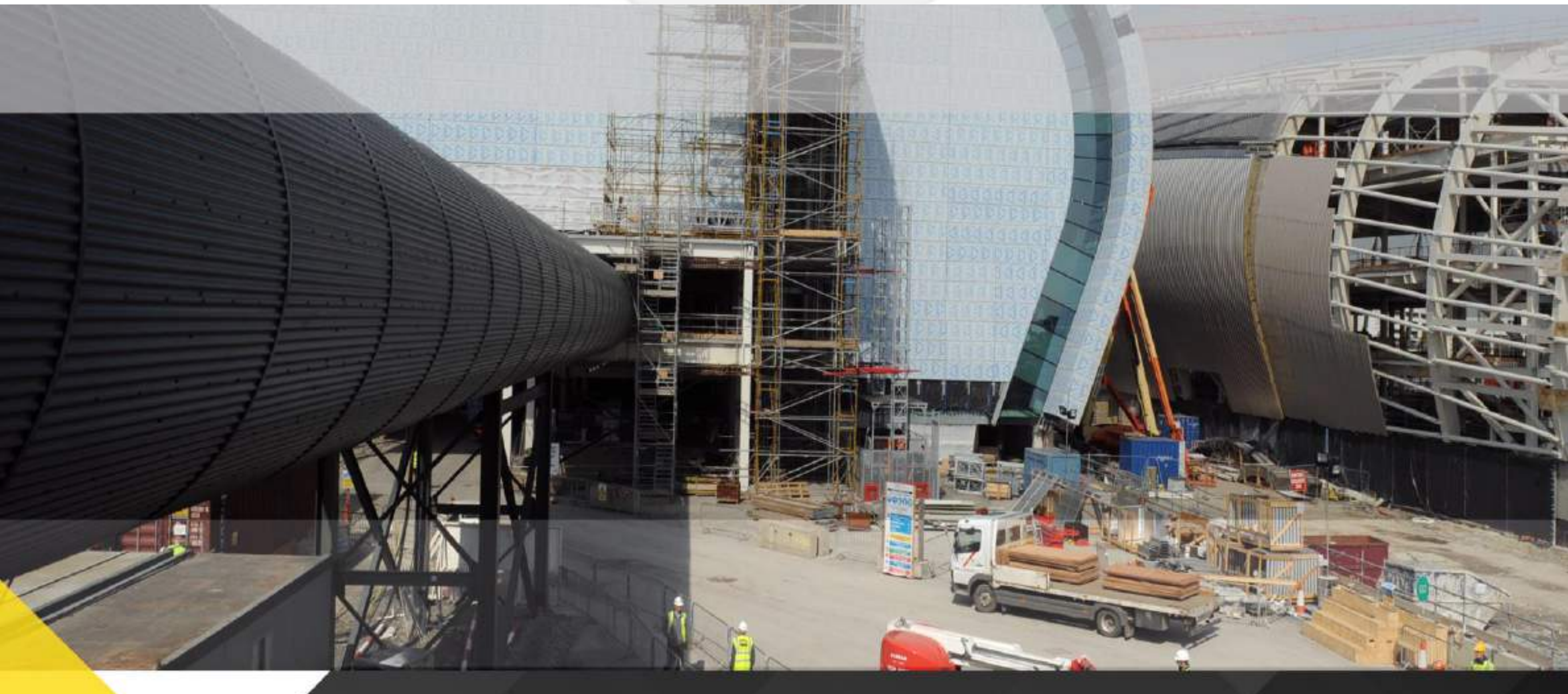
Political Risk Insurance is also underwritten by public entities such as the Multilateral Investment Guarantee Agency (MIGA), an arm of the World Bank, and the U.S. government's Overseas Private Investment Corp. (OPIC). These entities may offer alternative benefits to an organization. Using public entities essentially means that the World Bank or U.S. government become partners in the investment and thus, having a vested interest, can bring their enormous authority and leverage to bare on an investors behalf during difficult situations. In addition to this, there is legislation in the United States that allows the US government to ensure that its representatives in international financial institutions such as the IMF and the World Bank veto loans and benefits to countries that expropriate US investments without compensation. A drawback of the public market is the amount of time needed for the application process, typically close to a year or more, compared with 45 to 60 days for a private insurer.

A third form of insurance that can be utilized for large investment projects is the creation an international consortium of investors or bond holders whereby finance for a project is spread among a range of government backers. Creating an international network of countries whose vested interests would be disadvantaged by expropriation creates powerful friends and provides a large disincentive for host governments to expropriate.

Build, Operate and Transfer

In some circumstances such as large infrastructure or manufacturing projects, contracts can be set up in a “Build, Operate and Transfer” structure whereby a foreign investor builds the infrastructure and then operate it for a determined period of time before transferring ownership over to the host government. The term of operation, generally 25-30 years, is usually long enough that a profit can be realized on the initial investment. The arrangement allows host governments to utilize foreign technological, financial and organizational knowledge and experience without fully privatizing key infrastructure. The model provides a keen disincentive for expropriation given the asset will eventually be inherited by the host government anyway. It also allows foreign investors access to markets that would otherwise be too difficult or risky to undertake large scale investment projects in.

An excellent example of the ‘Build, Operate then Transfer’ model is the Antalya International Airport in Turkey. In 1996 the Turkish government was under pressure to invest in new airport facilities as passenger numbers started to exceed capacity. Without the requisite experience or technological know-how, and with limited access to international capital markets the State Airports Administration turned to the private sector. Under a Build, Operate then Transfer model 6 state of the art terminal buildings were built at a construction value of more than US$1 billion without being a burden to the country’s central budget.

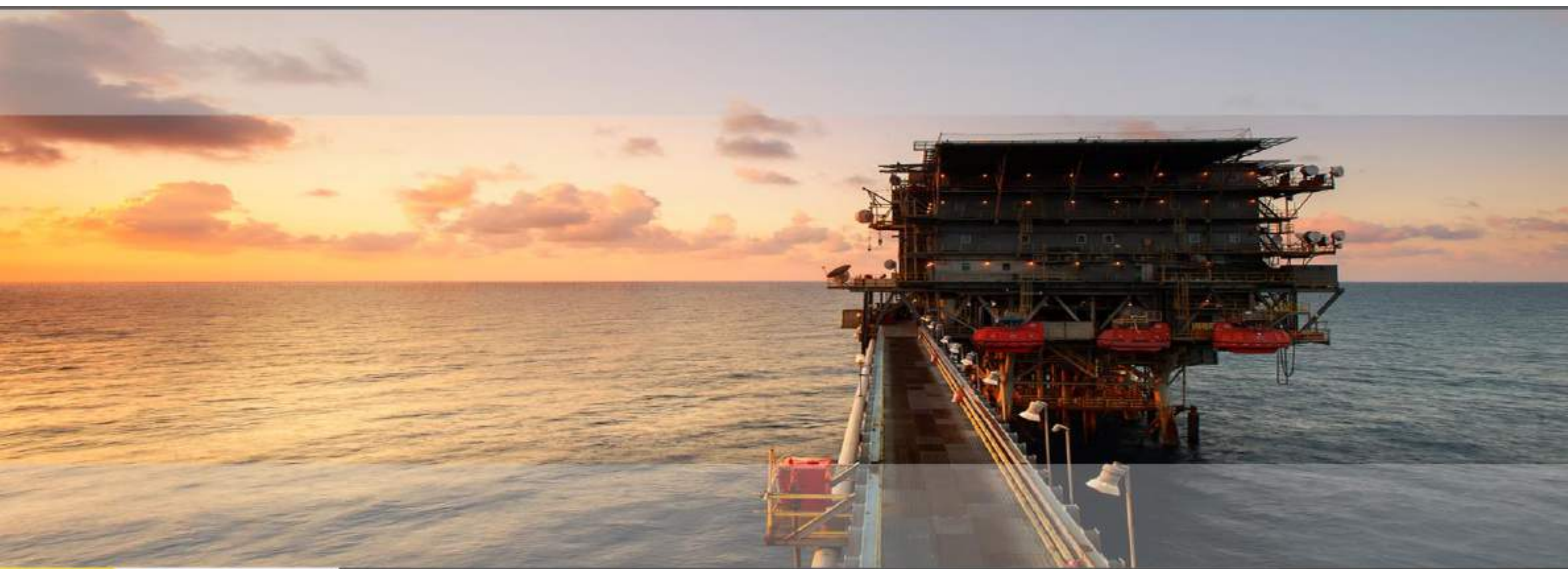


Conclusions

While civil wars and acts of terrorism may dominate media reports, expropriation risk remains the single biggest resulting factor in Political Risk Insurance claims by international investors. While the methods used by governments to expropriate have changed slightly over the last half century, events such as the Arab Spring remind us that the risks remain ever-present.

In an environment of growing geo-political instability and a changing international relations framework where old norms are being challenged, it is vitally important that these political risks are being properly identified, analyzed, contextualized and integrated into investment methodologies and corporate Enterprise Risk Management systems. Without the proper business critical information, political risks will go unmeasured and under-considered by key decision makers which could have calamitous effects for investors.

At Pozières Consulting Inc. we can identify, analyze and contextualize strategic political risks like expropriation risk and turn them into tangible, actionable business insights. We utilize a combination of in-depth thematic research, innovative analytic tools and tailored business intelligence gathering to provide a bespoke service to our clients. We ensure that our reporting is translated into a meaningful and functional format that can inform real business decisions and investment methodologies.



Pozières Consulting Inc is a Political Risk Advisory firm, providing bespoke analysis and business intelligence through our worldwide network of analysts and sources. We work with clients to identify, analyse and contextualise strategic Political Risks and turn them into tangible, actionable business insights. We utilise a combination of in-depth thematic research, innovative analytic tools and tailored business intelligence gathering to provide a bespoke service to clients. For comprehensive Political Risk advice and a confidential consultation, contact us at info@pozieresconsulting.com

Pozières Consulting

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